



Taxation of Tobacco Products: An Introduction to Key Terms & Concepts

“Of all the concerns, there is one—taxation—that alarms us the most. While marketing restrictions and public and passive smoking [restrictions] do depress volume, in our experience taxation depresses it much more severely. Our concern for taxation is, therefore, central to our thinking” – Philip Morris¹

Increasing tobacco taxes, which are passed along to consumers in the form of higher tobacco product prices, is one of the most effective ways to prevent and reduce tobacco use. Higher tobacco product prices encourage tobacco users to quit, sustain cessation, prevent youth initiation, and reduce consumption among those who continue to use tobacco. Further, the revenue generated through tobacco tax increases can provide much-needed funding for comprehensive tobacco control programs. Therefore, tobacco control advocates should continue to support the imposition of higher tobacco taxes. They should also promote tobacco tax equity, to ensure that other tobacco products are taxed at rates similar to those imposed on cigarettes.

When the Consortium provides legal technical assistance on tobacco tax initiatives, we sometimes are asked to explain the differences between different kinds of tobacco taxes, and various taxation strategies. This fact sheet is designed to answer some of the most frequently asked questions about tobacco taxation terminology and concepts.

Q. Are all tobacco products taxed in the same manner or at the same rate?

A. No. Cigarettes are usually taxed separately from other tobacco products (sometimes referred to as “OTPs”) like chewing tobacco, snuff, cigars, and little cigars. Other tobacco products can also be individually categorized and taxed differently from one another under state tobacco tax codes. There are special considerations for taxing novel smokeless tobacco products, which are discussed further below.

Q. Generally speaking, how are tobacco products taxed?

A. Tobacco products can be taxed in a number of different ways, through the imposition of excise taxes, sales taxes, and value-added taxes, or some combination thereof. Excise taxes are imposed on tobacco products at both the federal² and state³ levels. Some localities may also impose an excise tax on tobacco products if not preempted by state law.⁴ Additionally, states and localities may charge sales and other kinds of

taxes, or specific fees (e.g., cigarette litter mitigation fees), on tobacco products. Different types of tobacco taxes are discussed further below.

Q. What is an excise tax?

- A. An excise tax is an indirect tax on the sale of selected goods. It is considered indirect because the government does not directly apply the tax. Instead, excise taxes are included in the price of the product and collected from the producer, manufacturer, wholesaler, importer, or at the point of final sale to the consumer.

When tobacco control advocates talk about increasing tobacco taxes, they are generally referring to raising tobacco excise taxes.

Q. What types of excise taxes exist?

- A. There are two types of tobacco excise taxes: (1) **specific**, and (2) **ad valorem**.⁵

Specific excise taxes are a fixed dollar amount charged per a specific quantity (e.g. \$1.50 per cigarette, pack, kilogram, or pound). In contrast, *ad valorem excise taxes* (also known as percentage-of-price taxes) are charged as a certain percentage of the value of the product. The value of the product is measured either by the manufacturer's list price or by the retail price paid by the consumer.

The federal cigarette excise tax of \$1.01 per pack is a specific excise tax. At the federal level, other tobacco products are taxed at varying rates, on both specific and *ad valorem* bases, depending on the type of product in question.⁶ All fifty states and some localities have tobacco excise taxes. However, they differ considerably with regard to their rates and the types of tobacco products taxed. For details about the various tobacco excise taxes imposed throughout the country, visit the Campaign for Tobacco-Free Kids' [website](#), which has produced a number of informative [fact sheets](#) on different aspects of state and local tobacco taxation.

Q. Is a specific or an *ad valorem* excise tax on tobacco products preferable?

- A. There are advantages and disadvantages to both types of excise taxes.

Specific excise taxes are usually easier to administer and provide a more predictable revenue stream. Specific excise taxes also result in fairly uniform price increases among all tobacco products they are applied to, whereas *ad valorem* excise taxes can create larger price differences between cheaper and more expensive products, even within the same class of products. However, inflation can erode the value of specific excise taxes if periodic rate increases are not achieved. *Ad valorem* excise taxes, on the other hand, automatically adjust for inflation.

The tobacco industry can devise ways to circumvent the effects of both types of excise taxes. For instance, a manufacturer could reduce the effect of specific excise taxes by producing larger cigarette packs or lighter tobacco products, depending on

what quantity the tax is applied to (e.g., per pack, per ounce, etc.). A manufacturer could also limit the effectiveness of *ad valorem* excise taxes by producing lower-priced products.

Q. Is an excise tax different than a sales tax?

- A.** Yes. In addition to excise taxes, states and localities may impose another indirect tax on tobacco products such as a sales tax. A sales tax is a consumption tax charged to the end consumer at the point of purchase for certain goods. It is an *ad valorem*-type tax in that it is applied as a specific percentage of a product's value (in the case of tobacco products, it is a percentage of the product's retail price).

States and localities differ considerably with regard to sales tax rates and whether they apply to tobacco products. For example, Alaska, Delaware, Montana, New Hampshire, and Oregon have no state retail sales tax at all. Minnesota and Oklahoma have a state sales tax but do not apply it to cigarettes, and Alabama, Georgia, and Missouri (unlike the rest of the states) do not apply their state sales tax to that portion of retail cigarette prices that represents the state's cigarette excise tax.⁷

Q. What is a value-added tax?

- A.** A value-added tax is another type of consumption tax. Value-added taxes are used more commonly in other countries than in the United States. A value-added tax (VAT) is charged as a percentage of the value added to a product at each stage of its production.⁸ For example, tobacco growers and cigarette manufacturers are each charged a tax on the value they added to their respective stage of a cigarette's production. A value-added tax is similar to a sales tax in that it is also an *ad valorem* tax. However, a VAT differs from a sales tax in that the latter is only collected once from the end consumer, whereas with a VAT, the tax is paid each time a business in the supply chain sells the product to a buyer. While businesses may be able to recover the VAT as tax credits, the end consumer cannot.

Q. How are smokeless tobacco products taxed?

- A.** Smokeless tobacco products are taxed predominantly in two ways: (1) on an *ad valorem* (percentage of price) basis; and (2) by weight, which is a *specific excise* tax. Several states tax conventional smokeless tobacco products, such as moist snuff, by weight, which can be problematic. The tobacco industry has recently developed dissolvable tobacco products (e.g., lozenges, orbs, sticks, and strips) that are very low-weight, and thus significantly under-taxed pursuant to weight-based taxation schemes.⁹

One potential alternative to ineffective weight-based smokeless tobacco product taxes is to set minimum tax rates or minimum selling prices for each major category of other tobacco products. Another alternative is to tax smokeless tobacco products on an *ad valorem* basis, as a percentage of their wholesale price (sometimes referred to as the manufacturer's price). For more information about the best way to tax

smokeless tobacco products, consult this [fact sheet](#) by the Campaign for Tobacco-Free Kids.

Q. What is meant by the terms “tobacco tax parity” or “tobacco tax equalization”?

- A. These terms refer to the idea that taxes on other tobacco products should be similar and tied to the tax rates imposed on cigarettes, so that OTP tax rates automatically increase when cigarette excise taxes are raised. Historically, other tobacco products such as little cigars have been taxed at much lower rates than cigarettes, even though they are essentially the same thing and their use carries similar health risks. Many jurisdictions are in the process of modernizing their tobacco tax statutes,¹⁰ to ensure that other tobacco products (including the new, low-weight dissolvable products) are not under-taxed. The underlying concern is that, in the face of rising cigarette excise taxes, smokers may turn to lower-priced alternatives like little cigars, rather than quit. Under-taxation of smokeless tobacco products also costs states millions of dollars in lost tax revenues that are sorely needed at a time of widespread state budget deficits and decreased spending on tobacco control programs.

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Notes

¹ Philip Morris internal document, “General Comments on Smoking and Health,” Bates No. 2023268329/8348, *The Perspective of PM International on Smoking and Health Initiatives*, App. I (Mar. 29, 1985).

² In 2009, the federal excise tax on cigarettes increased from \$0.62 to \$1.01 per pack. As a result of the same legislation, little cigars and roll-your-own (RYO) tobacco are now taxed at an equal rate to cigarettes at the federal level. U.S. Centers for Disease Control & Prevention (CDC), Federal and State Cigarette Excise Taxes –United States, 1995-2009, 57 MORBIDITY & MORTALITY WEEKLY RPT. 524 (May 22, 2009), available at <http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5819a2.htm>.

³ As of August 2010, the average state cigarette tax rate was \$1.45 per pack. State cigarette tax rates range from a high of \$4.35 per pack (New York), to a low of \$.17 per pack (Missouri). Campaign for Tobacco-Free Kids, Map of State Cigarette Tax Rates (Aug. 3, 2010), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0222.pdf>.

⁴ The highest combined state-local tax rate is \$5.85 in New York City, with Chicago, Illinois second at \$3.66 per pack. Evanston, Illinois and Anchorage, Alaska also have high combined state-local tax rates. Campaign for Tobacco-Free Kids, State Cigarette Excise Tax Rates and Rankings (Aug. 3, 2010), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0097.pdf>. For more information about local cigarette taxes, see Campaign for Tobacco-Free Kids, Top Combined State-Local Cigarette Tax Rates (Jun. 23, 2010), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0267.pdf>.

⁵ Latin for “according to value.”

⁶ See Campaign for Tobacco-Free Kids, New Federal Tobacco Product Tax Rate Increases (Feb. 12, 2009), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0343.pdf>.

⁷ Campaign for Tobacco-Free Kids, State Cigarette Excise Tax Rates and Rankings (Aug. 3, 2010), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0097.pdf>.

⁸ See James R. Hines, Jr., *Taxing Consumption & Other Sins*, 21 J. ECON. PERSPECTIVES 49 (2007).

⁹ Campaign for Tobacco-Free Kids, Closing Weight-based Tax Loopholes for the New Generation of Low Weight Moist Snuff Smokeless Tobacco Products (Jun. 7, 2011), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0355.pdf>.

¹⁰ See, e.g., the Minnesota Tobacco Modernization and Compliance Act, Minn. Session Laws Ch. 305/S.F. 3055 (2010), available at <https://www.revisor.mn.gov/laws/?key=57965>. A summary of the major provisions of this legislation is available on the website of the Public Health Law Center, the Consortium’s parent organization, at <http://publichealthlawcenter.org/content/passage-tobacco-modernization-and-compliance-act-2010>.